

1995

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Recommended Citation

Steve Thel, *Section 12(2) of the Securities Act: Does Old Legislation Matter?*, 63 Fordham L. Rev. 1183 (1995).

Available at: <https://ir.lawnet.fordham.edu/flr/vol63/iss4/9>

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ESSAY

SECTION 12(2) OF THE SECURITIES ACT: DOES OLD LEGISLATION MATTER?

STEVEN THEL*

THE “fundamental purpose” of the federal securities laws, according to the Supreme Court, is “to substitute a philosophy of full disclosure for the philosophy of *caveat emptor*.”¹ Privately initiated litigation is the primary vehicle for assuring that what those selling securities disclose is true.² The law under which security buyers recover from those who make misrepresentations has been intensely criticized since the Securities Act was enacted in 1933. The law has changed greatly since then. Pressure for further change continues, and private securities litigation is probably more controversial now than ever.

This Term, the Supreme Court is faced with an extraordinarily difficult question about the liability of those who make misrepresentations while selling securities. *Gustafson v. Lloyd Co.*³ presents the question of whether section 12(2)⁴ of the Securities Act—which requires those who make false statements while selling securities to refund their buyers’ money—applies in privately negotiated transactions. The Court’s strong inclination to discourage private securities litigation indicates a narrow scope for section 12(2). At the same time, the clear language of the statute indicates a broad scope. The conventional wisdom is that this is an easy choice: the Court should follow the dictate of the statute. However, the Court may well reject that answer, and perhaps it should. A broad construction of section 12(2), in keeping with the statutory language, will substantially change prevailing law, which itself is different from that originally created by the federal securities statutes. At the same time, the strength of the legislative command embedded in section 12(2) has weakened considerably since the statute was enacted. The Supreme Court ought not lightly abandon the

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1. *Central Bank v. First Interstate Bank*, 114 S. Ct. 1439, 1445 (1994) (quoting *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972) (omitting internal quotation marks)). The same language is used in *Santa Fe Indus. v. Green*, 430 U.S. 462, 477 (1977) (also quoting *Affiliated Ute Citizens*, 406 U.S. at 151 (quoting SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963))); see also *Schreiber v. Burlington N., Inc.*, 472 U.S. 1, 6-7 (1985) (quoting *Santa Fe*, 430 U.S. at 477).

2. Over 90% of the securities cases brought in federal courts are initiated by private parties. See 1990 Director Admin. Office of the U.S. Courts, Annual Report supp. tbl. S-8.

3. No. 92-2514, 1993 U.S. App. LEXIS 36891 (7th Cir. June 11, 1993), cert. granted, 62 U.S.L.W. 3585 (U.S. Mar. 7, 1994).

4. 15 U.S.C. § 77l(2) (1988).

rule of law; but, when it decides the scope of section 12(2), it should follow its own judgment of whether it is wise to limit the remedies available in securities fraud litigation, even if that judgment conflicts with the statute.

Reflexive obedience to the command of section 12(2) may be inappropriate, because, in the sixty years since the statute was enacted, the federal law of private liability for misrepresentations in securities transactions has become an ocean of common law, with only a few inconsequential statutory islands. In this situation, *Gustafson* poses an acute dilemma for the Court that simple models of statutory construction cannot easily solve.

I. THE DEBATE OVER THE SCOPE OF SECTION 12(2)

Disappointed securities investors who sue usually seek to recover for violations of rule 10b-5.⁵ Courts have consistently held that private parties can recover for violations of this rule, notwithstanding that the rule and the statute under which it was adopted are silent on the matter.⁶ Critics have worried over private rule 10b-5 litigation for a long time, and the Supreme Court, in a string of cases over the past twenty years, has limited the relief available to private plaintiffs for violations of the rule.⁷

As the Supreme Court has made it more difficult for private parties to prevail under rule 10b-5, unhappy investors have turned to section 12(2) of the Securities Act.⁸ Although section 12(2) is an integral part

5. 17 C.F.R. § 240.10b-5 (1994).

6. See *infra* notes 30-31 and accompanying text.

7. See, e.g., *Central Bank v. First Interstate Bank*, 114 S. Ct. 1439, 1455 (1994) (holding that a private plaintiff may not maintain an aiding and abetting action under rule 10b-5); *Lampf, Pleva, Lipkind, et al. v. Gilbertson*, 111 S. Ct. 2773, 2782 (1991) (holding that private rule 10b-5 actions are governed by a relatively short one to three year limitations period); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 473-74 (1977) (requiring proof of manipulation and deception to maintain an action under rule 10b-5); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976) (requiring proof of "scienter"—intent to deceive, manipulate, or defraud—to maintain a private action under rule 10b-5); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 744 (1975) (limiting the availability of private rule 10b-5 suits to purchasers and sellers of securities). A few important decisions favor plaintiffs. See, e.g., *Basic Inc. v. Levinson*, 485 U.S. 224, 231-34 (1988) (adopting "reasonable investor" standard for materiality element and "fraud-on-the-market" theory for reliance element under rule 10b-5); *Herman & MacLean v. Huddleston*, 459 U.S. 375, 387, 390 (1983) (holding that private plaintiff may maintain a rule 10b-5 action even where a statutory express cause of action applies and rejecting Fifth Circuit's requirement of a "clear and convincing evidence" standard in favor of a "preponderance of the evidence" standard); *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153 (1972) (stating that positive proof of reliance is not a prerequisite to recovery under rule 10b-5); see also *Musick, Peeler & Garrett v. Employers Ins.*, 113 S. Ct. 2085, 2086 (1993) (holding that defendants in a rule 10b-5 action are entitled to seek contribution).

8. See Louis Loss, *The Assault on Securities Act Section 12(2)*, 105 Harv. L. Rev. 908, 910 (1992) [hereinafter Loss, *The Assault on Section 12(2)*]; Patricia A. O'Hara, *Erosion of the Privity Requirement in Section 12(2) of the Securities Act of 1933: The*

of the statutory remedial scheme, relatively few investors have proceeded under it until recently. As Professor Loss notes, section 12(2) has long been one of the best kept secrets of the securities laws.⁹ Courts have resolved most section 12(2) interpretative questions without much trouble,¹⁰ but one question has engendered sharp disagreement. That question is whether section 12(2) is available to all security purchasers or only to those who buy in public offerings. This question has divided the courts¹¹ and generated a substantial body of academic commentary.¹²

Broadly speaking, section 12(2) requires anyone who "sells a security . . . by means of a prospectus or oral communication, which includes an untrue statement of a material fact" to refund the buyer's money.¹³ Buyers get their money back even if they did not rely on the falsehood, so long as they did not know the truth at the time of

Expanded Meaning of Seller, 31 U.C.L.A. L. Rev. 921, 927-30 (1984); Therese H. Maynard, *Liability Under Section 12(2) of the Securities Act of 1933 for Fraudulent Trading in Postdistribution Markets*, 32 Wm. & Mary L. Rev. 847, 851 (1991) [hereinafter Maynard, *Liability Under Section 12(2)*]; Robert A. Prentice, *Section 12(2): A Remedy for Wrongs in the Secondary Market?*, 55 Alb. L. Rev. 97, 101-03 (1991); Robert N. Rapp, *The Proper Role of Securities Act Section 12(2) as an Aftermarket Remedy for Disclosure Violations*, 47 Bus. Law. 711, 712 (1992); Elliott J. Weiss, *The Courts Have It Right: Securities Act Section 12(2) Applies Only to Public Offerings*, 48 Bus. Law. 1, 4-6 (1992). Recent Supreme Court decisions limiting the defendants who may be held liable for violations of rule 10b-5 and the period during which actions may be brought are likely to make section 12(2) relatively more attractive to potential private plaintiffs. See *Central Bank*, 114 S. Ct. at 1455; *Lampf*, 111 S. Ct. at 2782.

9. Loss, *The Assault on Section 12(2)*, *supra* note 8, at 910; see also Maynard, *Liability Under Section 12(2)*, *supra* note 8, at 876 (noting that an express cause of action for fraud in connection with secondary trading is available under section 12(2), along with implied remedies under section 10(b)).

10. See Loss, *The Assault on Section 12(2)*, *supra* note 8, at 911-14 (discussing litigation on control person liability, respondeat superior, and the meaning of "seller").

11. Compare *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682, 693 (3d Cir. 1991) (holding that section 12(2) does not apply to trading transactions) with *Pacific Dunlop Holdings, Inc. v. Allen & Co.*, 993 F.2d 578, 595 (7th Cir. 1993) (holding that section 12(2) does apply to trading transactions, as well as to initial offerings), *cert. dismissed*, 114 S. Ct. 1146 (1994).

12. See, e.g., Harold S. Bloomenthal, *Securities Law Handbook* § 14.09(4) (1994); J. William Hicks, *Civil Liabilities: Enforcement and Litigation Under the 1933 Act*, 17(A) Clark Boardman Callaghan Sec. L. Ser. § 6.01 (1994); Steven W. Hansen et al., *Developments in Broker-Customer Litigation*, 25 Rev. Sec. & Commodities Reg. 193, 197-99 (1992); Loss, *The Assault on Section 12(2)*, *supra* note 8, at 914-17; Louis Loss, *Securities Act Section 12(2): A Rebuttal*, 48 Bus. Law. 47 (1992) [hereinafter Loss, *Securities Act Section 12(2): A Rebuttal*]; Therese Maynard, *The Future of Securities Act Section 12(2)*, 45 Ala. L. Rev. 817 (1994) [hereinafter Maynard, *The Future of Section 12(2)*]; Maynard, *Liability Under Section 12(2)*, *supra* note 8, at 854-57; Prentice, *supra* note 8, at 108-19; Rapp, *supra* note 8, at 714-18; Adam D. Hirsh, Comment, *Applying Section 12(2) of the 1933 Securities Act to the Aftermarket*, 57 U. Chi. L. Rev. 955, 957-61 (1990); Catherine Zucal, Comment, *Does Section 12(2) of the Securities Act of 1933 Apply to Secondary Trading?*, *Ballay v. Legg Mason Wood Walker, Inc.*, 65 St. John's L. Rev. 1179, 1179-83 (1991).

13. 15 U.S.C. § 77l(2) (1988).

purchase. Moreover, they need not prove (or even allege) that the seller acted culpably.¹⁴ Sellers can escape liability only by proving that they did not know that their statements were false and could not have known in the exercise of reasonable care.¹⁵ Thus, under section 12(2), a buyer can recover if she can prove that the seller made a negligent misrepresentation in a prospectus or oral communication.¹⁶ The buyer does not even have to prove the seller's negligence.

Although the meaning of the word prospectus in section 12(2) is hotly disputed, the statute itself defines "prospectus" to include essentially every writing used to offer or sell a security.¹⁷ If the statutory definition controls, then section 12(2) is available in almost every case in which a seller makes a false statement of a material fact while offering or selling a security, because almost any statement used to sell a security is part of an oral communication or a written offer. For example, a buyer would be able to recover merely by showing that the seller made a false statement in a telephone call or document used in connection with the sale.

Recently, defendants have argued, and courts generally have agreed, that section 12(2) applies only to sales of securities in public offerings.¹⁸ The courts' reasoning is essentially that the Securities Act is addressed primarily to public distributions of securities and thus that section 12(2) is available only to address misrepresentations made in a public distribution. Under this interpretation, if a broker makes a false statement while recommending the purchase of a security traded

14. See Loss, *The Assault on Section 12(2)*, *supra* note 8, at 912-13.

15. Only the seller is liable under section 12(2), however, so that the plaintiff cannot look to the broad range of defendants available (until recently at least) under rule 10b-5. Cf. *Central Bank v. First Interstate Bank*, 114 S. Ct. 1439, 1455 (1994) (holding that private plaintiff cannot maintain an aiding and abetting suit under rule 10b-5). Others may be derivatively liable under section 12(2). See Loss, *The Assault on Section 12(2)*, *supra* note 8, at 912-14 (discussing statutory control-person liability and respondeat superior). On the meaning of the term *seller* in section 12(2), see *id.* at 911; Maynard, *The Future of Section 12(2)*, *supra* note 12, at 73; O'Hara, *supra* note 8; cf. *Pinter v. Dahl*, 486 U.S. 622, 641-54 (1988) (construing the term *seller* in case brought under section 12(1)).

16. See Maynard, *Liability Under Section 12(2)*, *supra* note 8, at 859-60. In addition, plaintiff buyer must prove that she did not know of the misrepresentation at the time of purchase. See *id.* at 860-62. She need not prove, however, that she relied on the misrepresentation. See *id.* at 860.

17. Section 2(10) of the Act, 15 U.S.C. § 77(b)(10) (1988), says that the word "prospectus" means any communication by writing, radio, or television that offers any security for sale, and section 2(3), *id.* § 77(b)(3), defines the term "offer for sale" to include every attempt to dispose of a security for value. Section 2(10) of the Act excludes two forms of written offers from the definition of *prospectus*: tombstone advertisements and so-called "free-writing," which is a written offer sent or given after the effective date of a registration statement that is accompanied or preceded by a formal prospectus that meets the extensive requirements of section 10(a) of the Act. *Id.* § 77j(a).

18. Cases restricting the application of section 12(2) to the public offering context are discussed in Maynard, *Liability Under Section 12(2)*, *supra* note 8, at 855-70 and Maynard, *The Future of Section 12(2)*, *supra* note 12, at 823-34.

in the secondary market,¹⁹ or if a seller makes such a statement in connection with a privately negotiated trade,²⁰ no public offering is involved and section 12(2), therefore, is not available to the buyer.

Even if the above argument's premise—that the Securities Act is addressed to public offerings—is correct, the argument runs into the broad statutory definition of the phrase “prospectus” and the even broader “oral communication.” Professor Elliott Weiss offers an extensive response to this problem.²¹ He argues that the phrase “by means of a prospectus or oral communication” in section 12(2) must have been intended to limit the reach of the section, or it would have been left out. To import the statutory definition of prospectus, however, extends the scope of section 12(2) to all transactions, as just about every sale involves some written or oral offer.²² To give the prospectus clause some limiting effect, Professor Weiss insists, its words must be read to encompass less than the expansive scope indicated by the statutory definition of prospectus.²³ Professor Weiss argues that the clause's meaning should be found in section 12(2)'s statutory context, relevant legislative history and policy considerations.²⁴ He analyzes context, history and policy at length, and concludes that they “strongly suggest that Congress intended section 12(2) to apply only when securities are sold in a public offering.”²⁵

Although Professor Weiss makes a nice argument, most commentators disagree with him.²⁶ They argue that the language, structure and history of the Securities Act all point to a broad construction of section 12(2) covering private transactions and secondary market trading as well as public offerings.²⁷ The point of this Essay is that the language, structure and history of the Securities Act ought not to determine this debate—the Court is not bound by the statute—but perhaps

19. See, e.g., *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682 (3d Cir. 1991) (holding that section 12(2) does not afford a remedy to buyers of securities in the secondary market, even in the face of alleged oral misrepresentations made by brokers).

20. See, e.g., *Alloyd Co. v. Gustafson*, No. 92-2514, 1993 U.S. App. LEXIS 36891 (7th Cir. June 11, 1993), cert. granted, 62 U.S.L.W. 3585 (U.S. Mar. 7, 1994).

21. See Prentice, *supra* note 8, at 124.

22. In fact, the definition of *prospectus* does exclude some written communications, and it is at least plausible that section 12(2) uses the word to assure coverage of all communications but the excluded ones. See Steve Thel, Section 12(2) of the Securities Act Through the Lens of Free Writing (December 1994) (unpublished manuscript on file with the author).

23. Weiss, *supra* note 8, at 6-8.

24. *Id.* at 7-8. The definitions section of the Securities Act provides that the definitions govern unless the context indicates otherwise, and Professor Weiss suggests that this clause provides a statutory basis for reading the limiting phrase “in a public offering” into section 12(2). *Id.* at 15-16.

25. *Id.* at 45.

26. See sources cited *supra* note 12. Prentice, *supra* note 8, takes essentially the same position as Weiss.

27. I do not have a strong opinion on whether buyers in private and secondary-market transactions should be allowed to recover under section 12(2).

I should say that I think the language, structure and history of the Securities Act indicate a broad application for section 12(2), covering private transactions and secondary market trading, as well as public offerings. In any event, in this Essay I have nothing to contribute to the debate over the meaning of the statute except to note that when section 12(2) was enacted it was widely understood to apply to trading in outstanding securities and to privately negotiated transactions, as well as to public offerings.²⁸

28. See Arthur A. Ballantine, *Amending the Federal Securities Act*, 20 A.B.A. J. 85, 86 (1934) ("The liabilities provided for in the [Securities Act] in reference to dealing in securities that are not newly issued are less serious than those as to new issues . . ."); Arthur H. Dean, *The Federal Securities Act: I*, *Fortune*, Aug. 1933, at 50, 102 ("Section 12 imposes civil liability . . . upon anyone selling any security including outstanding securities . . . by means of a prospectus or oral communication which includes an untrue statement of a material fact."); William O. Douglas & George E. Bates, *Some Effects of the Securities Act Upon Investment Banking*, 1 U. Chi. L. Rev. 283, 297 (1933) ("It is obvious that the criminal penalties under § 17 and civil liabilities imposed under § 12 have no relation to public offers. Those liabilities follow even as respects a simple, isolated transaction in no sense public."); *id.* at 298 (noting that the element of public offer is absent from definition of prospectus); John Hanna & Edgar Turlington, *The Securities Act of 1933*, 7 S. Cal. L. Rev. 18, 31 (1933) (stating that section 12(2) applies to "any security, whether outstanding, registered or unregistered"); see also George C. Thorpe & Challen B. Ellis, *The Federal Securities Act Manual* § 123 (1933) (stating that "section 12(2), paragraph 2, of the Act applies to all securities"); Baldwin B. Bane, *The Federal Securities Act of 1933*, 14 B.U. L. Rev. 35, 41-42 (1934) (noting that section 12(2) gives a right of action to an immediate purchaser of securities against any seller providing a prospectus containing a misrepresentation or omission); Carl L. Bumiller, *Exemptions of Securities and Transactions Under the Federal Securities Act of 1933*, 10 U. Cin. L. Rev. 125, 133 n.22, 156 n.67, 157 n.69 (1936) (interpreting language of section 12(2) to extend protection to all buyers of securities, not just to those in public offerings); Douglas & Bates, *supra*, at 298-99; Friedrich Kessler, *The American Securities Act and Its Foreign Counterparts: A Comparative Study*, 44 Yale L.J. 1133, 1134 (1935); Allen E. Throop & Chester T. Lane, *Some Problems of Exemption Under The Securities Act of 1933*, 4 Law & Contemp. Probs. 89, 90 (1937) ("Except as regards fraud or negligent misrepresentation on the part of the seller . . . the administrative provisions of the Act are primarily directed to the problem of distribution, as distinguished from that of trading."); *Legislation*, 33 Colum. L. Rev. 1220, 1237 n.131 (1933) ("Although no person involved in a transaction exempted from registration . . . need send a prospectus, all prospectuses sent must be free from defects, or the liability imposed in § 12(2) applies.").

In 1941, the securities industry, with the concurrence of the SEC, recommended that section 12(2) be amended, and the premise of these recommendations was that section 12(2) applies to trading in outstanding securities. *Cf. Loss, Securities Act Section 12(2): A Rebuttal*, *supra* note 12, at 53 (discussing the 1941 amendment proposal).

Professor Weiss seems to acknowledge that contemporary statements claiming that section 12(2) applies to trading in outstanding securities are quite convincing evidence of what Congress intended. See Weiss, *supra* note 8, at 38; see also Prentice, *supra* note 8, at 137 (acknowledging that an SEC Commissioner stated that the application of section 12(2) is broad).

II. THE LEGAL BACKGROUND OF THE SECTION 12(2) DEBATE— PRIVATE RECOVERY FOR VIOLATIONS OF RULE 10b-5

The debate over section 12(2) would not have arisen if the Supreme Court had not made it so difficult for plaintiffs to recover for violations of rule 10b-5.²⁹ So long as it was relatively easy for a private party to recover under rule 10b-5, section 12(2) did not matter. Section 12(2) became important only after the courts held that buyers cannot recover for violations of rule 10b-5 unless they prove scienter and reliance.

Notwithstanding the vast number of private actions brought for violations of rule 10b-5, neither section 10(b) of the Exchange Act nor rule 10b-5 itself provides a private right of action for violations of the rule. Instead, courts created the private right of action and defined its parameters. Courts allowed private parties to recover for violations of rule 10b-5 almost as soon as the rule was adopted.³⁰ When the Supreme Court finally addressed the question in 1971, the unanimous Court disposed of the issue with a blunt, but accurate, single sentence in a footnote: "It is now established that a private right of action is implied under § 10(b)." ³¹

The Supreme Court did not decide its first rule 10b-5 case until a large body of law had already developed in hundreds of lower court decisions. A tremendous body of case law from the lower courts still governs innumerable questions. However, in more than a dozen cases, the Supreme Court itself has established most of the basic doctrines that govern private actions for violations of rule 10b-5. One set of Supreme Court cases has outlined the conduct forbidden by the rule. In these cases, the Court has implicitly assumed that rule 10b-5 forbids everything that the SEC can forbid and has focused on the question of what conduct is within the scope of the Commission's section 10(b) power.³² These cases established the core requirements of

29. See Loss, *The Assault on Section 12(2)*, *supra* note 8, at 909 ("The story started fifteen years ago with *Ernst & Ernst v. Hochfelder* . . .").

30. An implied right of action under rule 10b-5 was first recognized in 1946 in *Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 513-14 (E.D. Pa. 1946). The history of the judicial development of the rule 10b-5 private action has been told many times. See, e.g., *Herman & MacLean v. Huddleston*, 459 U.S. 375, 380-81 n.10 (1983) (tracing the development of case law on the issue of a private right of action under rule 10b-5).

31. *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 13 n.9 (1971); see also *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 729-30 (1975) (recognizing existence of private action for violations of rule 10b-5); *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 150-54 (1972) (same).

32. See Joseph A. Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Law: The Commission's Authority*, 107 Harv. L. Rev. 961, 977 (1994); Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 Stan. L. Rev. 385, 463 (1990).

deception³³ and scienter.³⁴ Early on, the Court indicated that deception can run afoul of the rule if it has even a slight connection with a securities transaction.³⁵ In its most recent rule 10b-5 case, the Court held that those who aid and abet violations of the rule cannot be held liable in a private action, and it suggested that the SEC may not pursue them either.³⁶

Most of the Court's rule 10b-5 cases are more narrowly directed. Rather than deciding what conduct is (or could be made) unlawful, they have addressed the relief available to private parties once a rule 10b-5 violation is established. The Court has created rules governing standing,³⁷ arbitrability,³⁸ affirmative defenses,³⁹ contribution,⁴⁰ the period during which actions must be commenced,⁴¹ the plaintiff's burden of proof⁴² and various aspects of causation.⁴³

Now that all of this has been said and done, there is a substantial body of law on private actions for violations of rule 10b-5. There are probably more than a thousand reported opinions.⁴⁴ Several multi-volume treatises and a substantial part of the securities-law encyclopedias are devoted to the rule,⁴⁵ as are uncounted law review articles.⁴⁶ Law teachers consider the Supreme Court's rule 10b-5 cases to be so

33. See *Santa Fe Indus. v. Green*, 430 U.S. 462, 471-74 (1977); see also *Dirks v. SEC*, 463 U.S. 646, 655-59 (1983) (holding that the duty to disclose information arises from the relationship between the parties and not merely from one's ability to acquire information because of one's position in the market); *Chiarella v. United States*, 445 U.S. 222, 235 (1980) (holding that the duty to disclose under rule 10b-5 does not arise from the mere possession of nonpublic information).

34. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 212 (1976); see also *Aaron v. SEC*, 446 U.S. 680, 687-702 (1980) (determining that scienter is an element of a rule 10b-5 violation).

35. See *Superintendent of Ins. v. Bankers Life & Cas.*, 404 U.S. 6, 10 (1971); *SEC v. National Sec., Inc.*, 393 U.S. 453, 466-69 (1969).

36. See *Central Bank v. First Interstate Bank*, 114 S. Ct. 1439, 1455 (1994).

37. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 747 (1975).

38. See *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 227-38 (1987).

39. See *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 318-19 (1985).

40. See *Musick, Peeler & Garrett v. Employers Ins.*, 113 S. Ct. 2085, 2091 (1993).

41. See *Lampf, Pleva, Lipkind, et al. v. Gilbertson*, 111 S. Ct. 2773, 2780-82 (1991).

42. See *Herman & MacLean v. Huddleston*, 459 U.S. 375, 380-82 (1983).

43. See *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) (materiality and reliance); *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 150-54 (1972) (reliance).

44. See *Loss, The Assault on Section 12(2)*, *supra* note 8, at 911.

45. See *Harold S. Bloomenthal, Securities and Federal Corporate Law* § 9 (1988); *Alan Bromberg & Lewis D. Lowenfels, Securities Fraud & Commodities Fraud* (1990); 2 *Thomas Hazen, Treatise on the Law of Securities Regulation* 51-219 (1990 & Supp. 1993); *Arnold S. Jacobs, The Impact of Rule 10b-5* (1980); 7, 8 *Louis Loss & Joel Seligman, Securities Regulation* 3485-3729 (3d ed. 1991).

46. See *Michael J. Kaufman, A Little "Right" Musick: The Unconstitutional Judicial Creation of Private Rights of Action Under Section 10(b) of the Securities Exchange Act*, 72 *Wash. U. L.Q.* 287, 287 n.2 (1994) ("More scholarship has been devoted to the private right of action for violations of section 10(b) than to any other securities law issue.").

fundamental that they are reproduced in the basic corporations casebooks and discussed at length in many introductory corporations courses. Perhaps because of this, most lawyers and judges (and probably legislators) know far more about rule 10b-5 than they do about any of the statutory provisions addressed to misrepresentation—including section 12(2).⁴⁷

III. THE RELEVANCE OF RULE 10B-5 TO THE MEANING OF SECTION 12(2)

Over the last twenty years, the Supreme Court has made it difficult for securities buyers to recover on the basis of misrepresentations made in the sale of securities. If the Court decides that section 12(2) applies to all securities transactions, it will effectively overturn much of this law. A broad construction of section 12(2) will allow people who buy securities in privately negotiated transactions or on the advice of their brokers to rescind those transactions if they can prove that the seller made an untrue statement of material fact. These buyers are not entitled to any relief under rule 10b-5 unless they also can prove that they relied on the misrepresentations⁴⁸ and that the sellers acted with scienter.⁴⁹

It seems inconceivable that when the Court decides *Gustafson* it will ignore the possible implications of its decision for the restrictive rules it has developed in its rule 10b-5 cases, but the academic commentators on the question would have them do so. While everybody who has weighed in on the debate over section 12(2) recognizes that the real issue is whether to allow recovery to buyers who cannot prove scienter or reliance, they also seem to think that the courts should decide the scope of section 12(2) without considering whether such plaintiffs should recover.⁵⁰ Even Professor Weiss agrees that the Court should not consider its history with rule 10b-5 in deciding whether section 12(2) applies to after-market trading and negotiated transactions.⁵¹

47. Cf. *Central Bank v. First Interstate Bank*, 114 S. Ct. 1439, 1445 (1994) (calling 10b-5 "the most familiar private cause of action").

48. See *Basic Inc. v. Levinson*, 485 U.S. 224, 250 (1988); *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 150-54 (1972). In these cases, the Court recognized a presumption of reliance when the false statement is disseminated into the market (*Basic*) or consists of a nondisclosure (*Affiliated Ute*). These presumptions substantially reduce the problem of proving reliance in many cases but would not assist the typical plaintiffs who desire a broad construction of section 12(2). Section 12(2) plaintiffs complain of misrepresentations in privately negotiated or broker-recommended transactions in which there are no presumptions of reliance.

49. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 212 (1976).

50. See, e.g., Loss, *The Assault on Section 12(2)*, *supra* note 8, at 916 (commenting that "to argue that the application of section 12(2) to ordinary trading would impinge on the rule's scienter requirement is to stand the art of statutory interpretation on its head").

51. See Weiss, *supra* note 8, at 35-36.

The objection to the Court's construing section 12(2) narrowly to preserve rule 10b-5 precedent is that to do so would usurp Congress' law-making power.⁵² The regime of private liability for violations of rule 10b-5 is judge-made law, and conventional notions of federal judicial power suggest that such law cannot serve as a basis for ignoring the statute. This is a powerful objection, and perhaps the Court should just apply section 12(2) literally, regardless of rule 10b-5. Nonetheless, the Court is likely to consider the 10b-5 issue, although it may not acknowledge doing so.⁵³ Despite the problem of apparent overreaching, if the Court believes that denying some classes of buyers the remedy of section 12(2) will improve the law, then the Court should consider doing so even though section 12(2) indicates that it is available to all buyers.

If the Supreme Court holds that section 12(2) applies to all securities transactions, it will profoundly change what has been the law for twenty years: that buyers of securities cannot recover in federal court for negligent misrepresentations and that they cannot recover on the basis of a face-to-face misrepresentation that they have not relied upon. That body of law, fashioned by courts under rule 10b-5, may be illegitimate, but it is real and substantial. If the Court substantially changes the law of private liability on the basis of its understanding of what Congress intended in enacting the Securities Act in 1933, this change will be made without *anyone* deciding that it is a change for the better.

Congress may have decided in 1933 that recovery should be allowed to all buyers under section 12(2) without proof of scienter or reliance—I think it did. However, Congress has not decided to change the substantial body of private-liability law that the courts have developed since then. Section 10(b) of the Exchange Act, the putative legislative base for rule 10b-5 liability, was not the law when section 12(2) was enacted. Even when section 10(b) was enacted in 1934, no one expected it to serve as a basis for private liability, let alone for a scheme of liability that would supplant most of what the statutes did.⁵⁴

52. See Jane S. Schacter, *Metademocracy: The Changing Structure of Legitimacy in Statutory Interpretation*, 108 Harv. L. Rev. 593, 594 ("Our legal culture's understanding of the link between statutory interpretation and democratic theory verges on the canonical and is embodied in the principle of 'legislative supremacy.' " (citation omitted)).

53. Cf. Nicholas S. Zeppos, *Judicial Candor and Statutory Interpretation*, 78 Geo. L.J. 353, 358 (1989) (criticizing theories that call for judges abandoning legislative intent and adopting candor in its place).

54. *Lampf, Pleva, Lipkind, et al. v. Gilbertson*, 111 S. Ct. 2773, 2780 (1991) (stating that "we have made no pretense that it was Congress' design to provide the remedy afforded" to private parties for violations of rule 10b-5); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 196 (1976) ("[T]here is no indication that Congress, or the Commission when adopting Rule 10b-5, contemplated a private right of action for violations of the rule."); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730, 737 (1975) ("[T]he plaintiff class for purposes of a private damage action under

If the courts are going to change the law by making section 12(2) recovery available to buyers who have been denied recovery under rule 10b-5, then the Supreme Court should decide whether this change is wise before it settles the question.

Conventional conceptions of the proper role of the courts in applying legislation are especially strained when it comes to applying section 12(2), because the courts radically changed the federal law of private recovery for securities fraud when they created the private remedy for violations of rule 10b-5. It is simply too late to say that law-making in this area is for Congress alone and not for the courts. The courts made law when they created the private right of action for violations of rule 10b-5, and they have been making it ever since. The private right of action for violations of rule 10b-5 is firmly established and is now more central to the regime of federal securities regulation than section 12(2) ever was. The courts are not going to abandon the private remedy for violations of rule 10b-5.

Given this history, when the Supreme Court decides the scope of section 12(2), it should not just focus on what Congress and the President intended in 1933. It should focus also on the implications of section 12(2) for the private-liability regime it has adopted under rule 10b-5. The Court should give section 12(2) the scope that it believes best serves a wise and coherent scheme of private liability.

This Essay does not undertake to develop a unifying theory of statutory construction or separation of powers that defines the Court's authority to ignore the mandate of legislation. However, there are two possible justifications for the Court's assumption of a law-making role in this area: the need for coherent and stable law, especially in light of changing circumstances, and the notion of delegated law-making power.

1. Coherent and Stable Law

It seems clear that the Supreme Court would not abandon the private right of action for violations of rule 10b-5 even if it concluded that the private action should not have been implied in the first place.⁵⁵ I am as convinced as anyone that most of the Court's rule

§ 10(b) and Rule 10b-5 was limited to actual purchasers and sellers of securities.”); Grundfest, *supra* note 32, at 986; Loss, *The Assault on Section 12(2)*, *supra* note 8, at 915-16; David S. Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of the Legislative Intent?*, 57 Nw. U. L. Rev. 627, 635 (1963); Thel, *supra* note 22, at 432 n.209; see also Musick, Peeler & Garrett v. Employer's Trust Ins., 113 S. Ct. 2085, 2088 (1993) (“The private right of action under Rule 10b-5 was implied by the judiciary.”).

Justice Stevens has suggested that the implication of a private right of action for violations of rule 10b-5 on a tort theory was in keeping with the intent of Congress. See *Central Bank v. First Interstate Bank*, 114 S. Ct. 1439, 1456 (1994) (Stevens, J., dissenting); *Lampf*, 111 S. Ct. at 2783-84 (Stevens, J., dissenting).

55. See *supra* note 54 (discussing cases in which the Supreme Court has suggested that Congress did not intend to create a private remedy for violations of rule 10b-5).

10b-5 jurisprudence is wrong, but I do not think that the Court should reverse itself now. Even Supreme Court justices who are quite hostile to the judicial creation of private actions for the violation of statutes and who are begrudging of an expansive construction of rule 10b-5 seem to regard the private action for violations of rule 10b-5 as too well established to be overturned.⁵⁶

The cases that created the private right of action under rule 10b-5 counsel a narrow construction of section 12(2). Of course, none of these cases states that a section 12(2) action is not available to people who buy in the securities markets or in privately negotiated transactions. However, an expansive construction of section 12(2) would undermine the Supreme Court's restrictive treatment of private remedies for securities fraud. Courts ensure legal stability and coherence by following their own precedent.⁵⁷ For the same reasons, the Court should follow its rule 10b-5 cases when it decides the scope of section 12(2).

A problem with this argument is that section 12(2) clearly states that it is available to buyers in all transactions. In its rule 10b-5 cases, the Court has consistently said that it is simply doing what Congress wanted when it enacted the statutes. It stretches the functions of *stare decisis* to argue that the Court's construction of one part of the securities laws binds it to ignore the will of Congress clearly articulated in another part.

However, it is not entirely correct to say that the Supreme Court has been construing section 10(b) of the Exchange Act in its rule 10b-5 cases. In an important sense, the Court has been construing—or even making—the whole scheme of private liability for misrepresentations in securities trading.⁵⁸ For most of the time that the Court has been deciding rule 10b-5 cases, rule 10b-5 occupied the whole field of private liability for misrepresentations in the sale of securities, except for the few cases involving misrepresentations in effective registration

56. Justice Scalia is particularly hostile to the implication of private actions. *See, e.g.,* Thompson v. Thompson, 484 U.S. 174, 192 (1988) (Scalia, J., concurring) (noting that courts should "get out of the business of implied private rights of action altogether"); *see also* Lampf, Pleva, Lipkind, et al. v. Gilbertson, 111 S. Ct. 2773, 2783 (Scalia, J., concurring) (stating that it is "too lawless to be imagined" for a court to assert that it can create an appropriate statute of limitations because it has created the cause of action in the first place). Scalia, however, joined the Court's opinion in *Musick, Peeler & Garrett v. Employers Ins.*, which granted 10b-5 defendants a right to seek contribution, reasoning that in enacting recent statutes, Congress had acknowledged the rule 10b-5 private action. 113 S. Ct. 2085, 2089 (1993). Justice Thomas dissented in *Musick*, but wrote that "[w]e again have no cause to reconsider whether the 10b-5 action should have been recognized at all." *Id.* at 2092 (Thomas, J., dissenting).

57. *See* Patterson v. McLean Credit Union, 491 U.S. 164, 172-75 (1989).

58. In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 212 (1976) and *Aaron v. SEC*, 446 U.S. 680, 687-702 (1980), the Court indicated that its conclusion that negligent misrepresentations are not actionable under rule 10b-5 was consistent with, and perhaps dictated by, the scheme of federal regulation as a whole.

statements, for which the remedy of section 11 of the Securities Act was also available.⁵⁹ The Court has self-consciously acted as though it has been responsible for making the rules for the whole universe of private securities litigation, and in fact it has been. In most of its rule 10b-5 cases, the Court was deciding whether a private remedy was available, not just whether one was available under rule 10b-5.

In 1983, the Supreme Court had occasion to consider the implications of the overlap between rule 10b-5 and statutorily expressed private remedies, when it decided *Herman & MacLean v. Huddleston*.⁶⁰ In that case, the Court held that the rule 10b-5 action is available to redress false statements in a registration statement, notwithstanding that section 11 of the Securities Act provides a private remedy for false registration statements. *Huddleston* expanded the set of remedies available to security buyers by giving them a remedy that Congress had declined to provide. If the Court gives section 12(2) a narrow scope on the basis of its rule 10b-5 cases, it will simply be giving sellers a set of defenses that Congress declined to give in 1933.

The effect of *Huddleston* was that the judicially created private remedy for violations of rule 10b-5 survives inconsistent statutory law.⁶¹ If section 12(2) is made available to buyers in the market or in negotiated transactions, the restrictive doctrines that the Court has developed in its rule 10b-5 decisions will no longer matter in many cases. Section 12(2) will provide an alternative remedy for a substantial number of buyers whose complaints have traditionally been denied under rule 10b-5, and it will allow those buyers to recover in circumstances in which the Court has decided recovery is inappropriate. A broad construction of section 12(2) that destroys the constraints that the Court has developed for private litigation under rule 10b-5 would be inconsistent with the decisions that created those constraints. Respect for those decisions requires a narrow construction of section 12(2). In any event, if the Court ignores the language of section 12(2) and gives it a restrictive reading, it may actually move Congress finally to revisit the whole issue of private liability. Ironically, overt judicial law making may be just what is needed to ensure that securities law is legislative.⁶²

Whether the Court has been construing the whole of the federal securities laws or only section 10(b) of the Exchange Act in its rule 10b-5 cases, the fact that the rule 10b-5 cases address in detail the

59. See 15 U.S.C. § 77k (1988).

60. 459 U.S. 375 (1983).

61. See Mary Siegel, *The Interplay Between the Implied Remedy Under Section 10(b) and the Express Causes of Action of the Federal Securities Laws*, 62 B.U. L. Rev. 385, 392 (1982) (discussing inconsistencies between section 11 and rule 10b-5).

62. Cf. Lawrence C. Marshall, "Let Congress Do It": *The Case for an Absolute Rule of Statutory Stare Decisis*, 88 Mich. L. Rev. 177, 186 (1989) (condemning the notion that legislative silence in response to judicial decisions constitutes acquiescence).

same subject as section 12(2) may justify ignoring the expressed will of Congress, if that is what it takes to square section 12(2) with the rule 10b-5 cases. The Court would no more be making law if it ignored the language of section 12(2) than it was when it recognized and developed the private right of action for rule 10b-5; a substantial part of the law of private remedies has been made by the courts, not by Congress. Having taken responsibility for making the law, the Court is not obliged to pull up short now. The point is not that having ignored Congress when they created the private right of action for rule 10b-5 violations, the courts can continue to ignore Congress now. Rather, the point is that having ignored Congress then, the courts are no longer able to do what Congress commanded.

Much of the substantial body of law that has developed around rule 10b-5 addresses the same subject as does section 12(2). This redundancy complicates the interpretation and application of section 12(2). Even if *stare decisis* does not justify using the rule 10b-5 cases to rewrite section 12(2), section 12(2) now works in an environment that greatly differs from that prevailing in 1933. The question of the scope of section 12(2) is complicated by events that have occurred in the sixty years since the Securities Act was enacted; *Gustafson* would have been a much simpler case in 1935 than it is in 1995. These changed circumstances ought to be reflected in current construction.

Regardless of whether the law that the courts have developed under rule 10b-5 is good, if the Supreme Court endorses a broad, literal application of section 12(2) now, it will destroy a great deal of judicial product and unsettle the real expectations of participants in the securities markets that have presumably shaped business practices. Literal application of section 12(2) also will create discontinuities in the law governing recovery against those accountable under section 12(2) and those accountable only under rule 10b-5. Sellers who make false statements will face liability for disgorgement under section 12(2) even if they have not acted with scienter or caused any harm to their buyers. On the other hand, buyers and non-trading issuers that make false statements will face liability only under rule 10b-5, so that they will be liable only if they act with scienter and then only for the damages their false statements cause. These discontinuities may be appropriate, but they were not created by Congress. The Supreme Court should not sanction them unless it first decides that it is a good idea to do so.

As the Court decides *Gustafson*, it should consider post-enactment developments. Even a good agent trying to do exactly what Congress wanted could hardly be sure that Congress would want slavish devotion to the words of section 12(2), and, in this situation, the advantages said to flow from applying a statute as directed by its text would be bought at a substantial cost.

There is much to be said for considering post-enactment developments in applying statutes, and commentators have said much of it.⁶³ Two of the most prominent commentators who have suggested that sometimes courts ought to update or reinterpret statutes in the light of changed circumstances conclude that updating is inappropriate when the statute is clear on its face.⁶⁴ This caveat comes to bear on the question of the scope of section 12(2), for the language of section 12(2) is unambiguous. Of course, ambiguity can be found in any statutory language, although if section 12(2) is ambiguous, the ambiguity requirement for judicial updating is of little consequence. In any event, it is not clear why courts can update statutes as a general matter but not if they are unambiguous. Perhaps those who would condition the judicial power to update statutes on ambiguity worry that judicial updating that contravenes the clear, unambiguous language of a statute would highlight the conflict between a regime of judicial amendment and conventional norms of legislative supremacy.⁶⁵ Yet whatever justifies a court's considering post-enactment developments in applying a statute is at work however clear the statute is. Section 12(2) presents a particularly compelling case for judicial updating, notwithstanding its admirably clear language.

2. Delegated Law-making Power

If the Supreme Court says that it is ignoring section 12(2) to keep the law coherent or because the statute was made for a different time, *Gustafson* will have implications outside securities law. The peculiar development of the law of private liability for securities fraud may

63. See, e.g., Guido Calabresi, *A Common Law for the Age of Statutes* 31-43 (1982) (discussing the modern judicial role in the face of the increasing "statutorification" of American Law); T. Alexander Aleinikoff, *Updating Statutory Interpretation*, 87 Mich. L. Rev. 20 (1988) (examining archeological statutory interpretation in two forms—textualism and intentionalism); Ronald Dworkin, *Law as Interpretation*, 60 Tex. L. Rev. 527, 531 (1982) (noting that propositions of law are more than simply straightforward descriptions of legal history; they also combine elements of description and evaluation); William N. Eskridge, Jr., *Dynamic Statutory Interpretation*, 135 U. Pa. L. Rev. 1479 (1987) (observing that it is odd that many judges consider only the text and historical context when interpreting statutes, because judges consider the subsequent interpretational history of constitutional and common law issues); Cass R. Sunstein, *Interpreting Statutes in the Regulatory State*, 103 Harv. L. Rev. 405, 422-24, 493-97 (1989) (recognizing that many disputes over statutory meaning are in fact disagreements over appropriate background norms); see also Schacter, *supra* note 52, at 631-36 (commenting on theories that support judicial interpretation based on current values and pragmatism, rather than on historical notions).

64. Eskridge, *supra* note 63, at 1496-97, 1542-44; Sunstein, *supra* note 63, at 493-97; see also Aleinikoff, *supra* note 63 (suggesting that statutes should be read as though they were enacted yesterday).

65. See Sunstein, *supra* note 63, at 494 n.371; see also Martin H. Redish & Theodore T. Chung, *Democratic Theory and the Legislative Process: Mourning the Death of Originalism in Statutory Interpretation*, 68 Tul. L. Rev. 803, 831-37 (1994) (criticizing dynamic interpretation as a usurpation of legislative authority); Zeppos, *supra* note 53, at 385-89.

justify the Court's ignoring the statute, but courts do not often claim the power to ignore statutes even in unusual situations. Recent legislation on private securities litigation, however, can fairly be read to delegate broad law-making power to the courts. That delegation may serve as a basis on which the Court can lawfully ignore the clear import of section 12(2).

As the courts developed the law of private liability for misrepresentations in the sale of securities, Congress generally deferred. However, Congress occasionally made adjustments expressed in oblique statutes.⁶⁶ A substantial body of legislation dealing with particular aspects of the private right of action for securities fraud has been enacted in the last ten years. This legislation has codified certain judicially developed doctrines and secured certain aspects of the private right of action for violations of rule 10b-5. Nonetheless, Congress has refrained from defining the law's parameters. Instead, it has left the formulation of the private liability regime to the courts.

The Insider Trading Sanctions Act of 1984 ["Sanctions Act"],⁶⁷ the Insider Trading and Securities Fraud Enforcement Act ["Enforcement Act"]⁶⁸ of 1988 and the statute of limitations for previously initiated rule 10b-5 actions recently added to the Exchange Act all seem to ratify and codify the courts' power to make the law of private liability for rule 10b-5 violations. The Sanctions Act, the Enforcement Act and the limitations provision are all premised not merely on the existence of a private remedy for violations of rule 10b-5 but also on the proposition that courts appropriately make the law governing private liability.

Among other things, the Sanctions Act makes it unlawful to trade options while in possession of material, non-public information emanating from the issuer of the underlying stock. It also allows public options traders to recover from insiders who unlawfully trade options. Neither reform was accomplished by direct or complete statutory command. Instead, the statute provides that options trading is unlawful when trading the underlying stock is unlawful and says that public options traders have a right to recover against insider option traders "comparable" to the right of public stock traders against insiders who unlawfully trade stock.⁶⁹ The Sanctions Act does not say when trading stock is unlawful or when public stock traders can recover. Instead, the Sanctions Act's options-rules build entirely on the judicially

66. See Steve Thel, *Section 20(d) of the Securities Exchange Act: Congress, the Supreme Court, the SEC and the Process of Defining Insider Trading*, 69 N.C. L. Rev. 1261, 1269 (1991).

67. Pub. L. 98-376, 98 Stat. 1264 (1984) (codified in scattered sections of 15 U.S.C.).

68. Pub. L. No. 100-704, 102 Stat. 4677 (1988) (codified in scattered sections of 15 U.S.C.).

69. Securities Exchange Act of 1934 § 20(d) (codified as amended at 15 U.S.C. § 78t(d) (1988)).

created rules on insider stock trading, and the Sanctions Act does not even restate those rules. Moreover, so far as the Sanctions Act goes, if the courts change the law of insider stock trading in the future, that change will also govern insider option trading.⁷⁰ This technique of incorporating judge-made law into the statute brings forward to the options area all the questions about what stock trading is illegal and actionable and adds its own complications about how the statute changes things.⁷¹ Nonetheless, Congress decided to piggyback on judge-made law rather than saying what it wanted on its own.

Four years later, Congress again built upon and incorporated judge-made law in the Enforcement Act, which gives contemporaneous traders a right of action against those who trade securities in violation of rule 10b-5 while in possession of material, non-public information.⁷² Once again, the statute does not say when trading violates the rule; that question must be answered by reference to case law. Congress' failure to set out just what is unlawful is particularly telling here, for Congress was under intense pressure to do so.⁷³ Nonetheless, Congress chose to leave the development of the law to the courts.

The most recent legislation dealing with private rule 10b-5 actions is the 1991 amendment to the Exchange Act that purported to restore the old statute of limitations for private actions initiated before the Supreme Court decided *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*.⁷⁴ That legislation established a limitations period for "any private civil action implied under [section 10(b)] that was commenced" before the Supreme Court decided *Lampf*, and directed federal courts to reinstate such actions that had been dismissed by retroactive application of *Lampf*.⁷⁵ Despite considerable support for legislation that would have provided an explicit limitations period for private rule 10b-5 actions, Congress left *Lampf* as the law for future cases and simply attempted to limit the decision's retroactive effect.⁷⁶ Even in that limited field, the statute did not state a limitations period

70. Similarly, the treble damages provisions of the ITSA, 15 U.S.C. § 78u-1(a)(2) (1988), are triggered by illegal trading or tipping. The question of legality is determined by reference to case law.

71. See Donald C. Langevoort, *The Insider Trading Sanctions Act of 1984 and Its Effect on Existing Law*, 37 Vand. L. Rev. 1273, 1290-91 (1984); William K.S. Wang, *A Cause of Action for Option Traders Against Insider Option Traders*, 101 Harv. L. Rev. 1056, 1057 (1988).

72. See 15 U.S.C. § 78t-1 (1988).

73. See Grundfest, *supra* note 32, at 996-97; see also Donald Langevoort, *Insider Trading: Regulation, Enforcement & Prevention* 2-21 to 2-23, 13-1 to 13-3 (1994) (discussing Congressional action and inaction in the area of insider trading law in the 1980s).

74. 111 S. Ct. 2773 (1991).

75. Securities and Exchange Act of 1934 § 27A (codified as amended at 15 U.S.C. § 78aa-1 (Supp. IV 1991)).

76. See Grundfest, *supra* note 32, at 997; Kaufman, *supra* note 46, at 333; Craig W. Palm, *The Constitutionality of Section 27A of the Securities Exchange Act: Is Congress Rubbing Lampf the Wrong Way?*, 37 Vill. L. Rev. 1213, 1261-63 (1992).

for actions pending when *Lampf* was decided. It instead provided that those actions were to be governed by the "limitation period provided by the laws applicable in the jurisdiction, including principles of retroactivity," the day before *Lampf* was decided.⁷⁷ Once again, Congress decided that these cases should be governed by judge-made law, even though the process of determining that law was likely to be preposterously complicated.⁷⁸

In the Sanctions Act, the Enforcement Act and the limitations legislation, Congress has acknowledged that the courts make the law of private liability for securities fraud and established a regime that contemplates the courts' continuing to do so. This delegation of law-making power has not been lost on the courts themselves. In 1993, when the Supreme Court addressed the issue of contribution among rule 10b-5 violators in *Musick, Peeler & Garrett v. Employers Insurance*, it made its by-then standard disclaimer that because the courts created the private remedy for violations of rule 10b-5, they cannot now refuse to make law on the theory that only Congress can make law.⁷⁹ The Court went on, however, to suggest that the courts now have statutory authority to regulate private remedies for misrepresentations in the sale of securities. The Court observed that in the Enforcement Act and the post-*Lampf* limitations statute, Congress took account of the Court's cumulative work in designing the private action, and the Court cited those statutes as evidence that Congress recognized "a judicial authority to shape, within limits, the 10b-5 cause of action."⁸⁰ "Indeed, the [limitations statute] not only treats the 10b-5 action as an accepted feature of our securities laws, but avoids entangling Congress in its formulation. That task, it would appear, Congress has left to us."⁸¹

If a legislature wants to authorize the courts to repeal a statute, maybe it ought to say so quite clearly. Congress has not in so many words said that the courts can repeal section 12(2). The three legislative initiatives discussed above address problems with the private remedy for violations of rule 10b-5 and respond to law developed by courts in that context. However, in those statutes Congress has counted on the courts to make the law of private liability for securities fraud, and Congress has spoken in enacted statutes, not through silent acquiescence. More than ratifying what the courts have done, these statutes gave the courts power to make the law of private liability for securities fraud. Indeed, each left the courts responsible for making the law even in the area it specifically addressed. In none did Con-

77. 15 U.S.C. § 78aa-1(a) (Supp. IV 1992).

78. See Jill E. Fisch, *As Time Goes By: New Questions About the Statute of Limitations for Rule 10b-5*, 61 Fordham L. Rev. S101, S115-16 (1993).

79. See 113 S. Ct. 2085, 2088-89 (1993).

80. *Id.* at 2089 (citation omitted).

81. *Id.* (citation omitted).

gress itself say what was illegal (or privately actionable) except by reference to existing law, which was almost entirely judge made. Whatever Congress did when it first enacted the securities statutes sixty years ago, it has since indicated that now the courts are to formulate the rules of private liability for securities fraud. In this situation, the Supreme Court will not overreach if it amends section 12(2).

CONCLUSION

It is likely that when the Supreme Court decides the scope of section 12(2), it will be guided by its history with rule 10b-5 and its sense of the policies that should define the law of private liability. The conventional vision of federal law-making, in which the courts play at most a supplemental role of filling gaps in legislation, indicates that the Court ought not to consider policy, but should concern itself only with what Congress did when it enacted the Securities Act. It will be unfortunate, however, if the Court ignores the merits of the law it will make when it decides *Gustafson*.

If section 12(2) of the Securities Act is now applied according to its terms, the law of private liability for misrepresentation in the sale of securities will change radically. Moreover, the regimes governing misrepresentation in securities transactions will differ substantially depending on who makes the misrepresentation and in what context the misrepresentation is made. This change, and the discontinuities it will introduce, may be for the best, but the Supreme Court should not make the change without considering whether it is wise to do so.

The Court can decide that the problems of a broad construction of section 12(2) justify giving the provision a narrow scope without claiming broad power to ignore a statute that it feels is unwise. The dispute over section 12(2) presents a special case because it requires interpreting the statute against the background of the judicially created law of private liability for rule 10b-5 violations. Once the courts established the private remedy for violations of rule 10b-5 and its parameters, it was impossible to return to the law established by Congress. The Court cannot do so now, no matter how it construes section 12(2).

In a sense, the Court's problem in *Gustafson* is to decide whether to follow the clear direction of the Congress that enacted section 12(2) in 1933 or to follow the apparent desire of more recent Congresses that courts shape private liability law as it sees best. Neither approach will yield a private liability regime firmly grounded in the statutes, but the latter is more likely to yield one that makes sense.

Recently, courts have been preoccupied with legislation and statutory interpretation, and many scholars have devoted themselves to the exploration of that subject. Much of their attention has been directed to the problem of applying ambiguous statutory language to a factual

circumstance the statute does not address clearly. The application of section 12(2) presents a tougher question, however, because the language of the statute is quite clear. Fortunately, other aspects of contemporary doctrine and scholarship on legislation do bear on the problems posed by section 12(2). This Essay has only sketched the problem and possible solutions. The controversy over section 12(2) presents this problem rather starkly, but principled arguments can be made for considering the law of rule 10b-5 when deciding how to apply section 12(2).